

Exhibit No. ____ T (WHW-1T)
Docket No. UT-090842
Witness: William H. Weinman

BEFORE THE WASHINGTON UTILITIES AND TRANSPORTATION COMMISSION

In the Matter of the Joint Application of
Frontier Communications, Inc. and
Verizon Communications, Inc.

DOCKET NO. UT-090842

For approval of Transfer of Control

TESTIMONY OF

WILLIAM H. WEINMAN

STAFF

OF

**THE WASHINGTON UTILITIES
AND TRANSPORTATION COMMISSION**

November 3, 2009

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Exhibit No. ____ (WHW-2) Applicants' Response to Staff Data Request No. 110
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Exhibit No. ____ (WHW-6) Applicants' Response to Public Counsel Data Request No. 97

1 **I. INTRODUCTION**

2

3 **Q. Please state your name and business address.**

4 A. My name is William H. Weinman. My business address is the Richard Hemstad
5 Building, 1300 S. Evergreen Park Drive S.W., P.O. Box 47250, Olympia, WA
6 98504. My e-mail address is wwainman@utc.wa.gov.

7

8 **Q. By whom are you employed and in what capacity?**

9 A. I am employed by the Washington Utilities and Transportation Commission ("UTC
10 or Commission") as Assistant Director – Telecommunications Section.

11

12 **Q. How long have you been employed by the Commission?**

13 A. I have been employed with the UTC since June 2007. I was also employed by the
14 UTC in a similar position from 1974 to 1978. I have been a Regulatory Analyst from
15 June 2007 through September 30, 2008. I have been in the Acting Assistant Director
16 or Assistant Director positions of the Telecommunications Section since October 1,
17 2008.

18

19 **Q. Please state your educational and professional background.**

20 A. I graduated from Washington State University in 1971 receiving a Bachelor of Arts
21 in Business Administration with a major in accounting. I am a member of the
22 American Institute of Certified Public Accountants.

1 My current responsibilities at the UTC generally include all issues in the
2 Telecom section, e.g., assigning dockets to staff, analyzing financial and accounting
3 issues, reviewing interconnection contracts between carriers, ensuring compliance
4 with UTC orders, reviewing intrastate access issues, providing expert analysis of
5 depreciation matters, and providing analyses in general rate cases, including tariff
6 filings and rulemakings involving investor-owned telecommunications companies
7 regulated by the UTC. Over my career, I have provided expert testimony before the
8 UTC regarding electric, natural gas and telephone companies. Most recently, I
9 reviewed and prepared testimony on depreciation and pole replacement in Avista's
10 general rate case, Docket No.UE-070804 and UG-070805. I participated as UTC's
11 Staff analyst in a settlement with PacifiCorp on depreciation rates and parameters
12 that the Commission adopted in Docket No. UE-071795. I provided testimony in the
13 Embarq Corporation and CenturyTel, Inc. petition to approve a transfer of control,
14 Docket No. UT-082119.

15 Between my prior and current employments with the UTC, I worked on
16 utility regulatory and operational issues for the consulting firm R.W. Beck (1979),
17 Ellensburg Telephone Company (1980-1984), Pacific Telecom, Inc. (1985-2003)
18 and Integra Telecom (2004-2007). I testified and was involved with regulatory
19 issues before the Oregon Public Utilities Commission as Vice President/General
20 Manager for Pacific Telecom from 1992 to 2003.

1 **Q. Please describe the scope of your testimony.**

2 A. My testimony addresses financial issues and the general policy foundation for Staff's
3 position on the proposed transaction. It also provides context for the specific
4 testimony of Ms. Jing Roth, Mr. Robert T. Williamson, Ms. Jing Liu, Ms. Kristen M.
5 Russell, Mr. Rick T. Applegate Ms. Suzanne Stillwell concerning the issues
6 presented by this proposed merger.

7
8 **II. SUMMARY OF TESTIMONY**

9
10 **Q. Please summarize your testimony.**

11 A. Staff has studied and analyzed the proposed transaction and concludes that the
12 Application to transfer control of Verizon Northwest, Inc. to Frontier
13 Communications Corporation is not in the public interest and the application should
14 be denied.

15 As an alternative to Staff's primary recommendation of denial, Staff
16 witnesses propose a number of conditions to mitigate risks associated with the
17 transfer, and to ensure some benefits to Washington customers to offset at least part
18 of the substantial harm that would result from the transfer of control. To be clear,
19 however, Staff believes there may not be any way for Frontier to provide benefits to
20 Washington customers that offset the financial harm and operational risks. The
21 failure of the companies to offer adequate consumer benefits or protections puts
22 customers at risk of being served by a company without enough financial strength to

1 make necessary improvements to local telephone facilities and widen deployment of
2 broadband access.

3

4 **Q. Does your recommendation to deny the application rely on the testimony of**
5 **other Staff members to support your decision?**

6 A. For the most part it does not. The other Staff members will provide testimony
7 recommending conditions for the Commission to require of Frontier if the
8 Commission decides to approve the transfer of control of Verizon NW to Frontier
9 Communications Corporation. However, I do rely on Robert Williamson's testimony
10 regarding the risks associated with operations support systems conversions.

11

12 **Q. Since there are multiple companies involved and both parents have subsidiary**
13 **companies, would you list the companies you will discuss in your testimony and**
14 **their abbreviations?**

15 A. The companies and their abbreviations are as follows:

16	Verizon Communications, Inc.	Verizon
17	Verizon Northwest, Inc. (operating company)	Verizon NW
18	Spinco	Not abbreviated
19	Frontier Communications, Inc	Frontier
20	Frontier Northwest, Inc. (new name for Verizon NW)	Frontier NW

21

1 **III. RISKS ASSOCIATED WITH THE TRANSFER OF CONTROL**

2

3 **Q. Before we discuss the risks or potential risks involved with this transaction,**
4 **what criteria did you use to evaluate the application to transfer control of**
5 **Verizon NW to Frontier.**

6 A. My understanding is that the standard used to review an application such as this is
7 the “no harm” standard. The transfer of control of a jurisdictional
8 telecommunications company should not cause harm to the Washington customers of
9 the transferred entity. My testimony will show that the customers of Verizon NW
10 would not only be harmed, but would also face unacceptable risks due to the lack of
11 verifiable data, the cost structure of Frontier and the financing issues associated with
12 the application.

13

14 **IV. FINANCIAL RISKS**

15

16 **Q. Would you summarize the reasons Staff is recommending the Commission deny**
17 **the application for transfer of control of Verizon NW?**

18 A. The reasons this application should be denied are as follows:

19 1. Frontier has a lower debt rating than Verizon which will result in increased
20 costs for Washington customers.
21 2. The increased Frontier debt costs will probably also result in higher equity
22 cost to Washington customers.
23 3. Verizon has a broader product line that helps offset the Washington access
24 line loss.
25 4. Data requests responses from Frontier show that the Company has not done
26 enough to investigate the condition of the plant it is acquiring or to determine
27 whether its own projections are realistic given the many risks the Company
28 identifies.

- 1 5. The merger agreement requires Frontier to issue additional equity if
- 2 regulatory agencies require additional expenditures by Verizon as a condition
- 3 of merger approval.
- 4 6. Frontier will be constrained from offering equity placements for two years
- 5 after the close date of the transaction.
- 6 7. Frontier is declaring and paying dividends that exceed earnings per share.
- 7 8. Risk factors disclosed by Frontier indicate there are substantial issues that
- 8 could affect the results of Frontier's projected financial results from the
- 9 merger.
- 10 9. Frontier is not able to give adequate interest rate cost estimates of the
- 11 additional debt (\$3.3 billion) needed to be issued by Frontier to make the
- 12 special cash payment to Verizon.
- 13 10. Frontier is not able to articulate the debt covenants that would be required to
- 14 issue \$3.3 billion dollars in debt.
- 15 11. Merger synergies will not provide any benefit to Washington customers.
- 16 12. Frontier discloses numerous risk factors in its Securities and Exchange Form
- 17 S-4, none of which are adequately addressed or assuaged in the company's
- 18 testimony or data request responses.
- 19
- 20
- 21

22 **Q. Briefly describe the mechanism the Applicants intend to use to complete the**
23 **proposed transaction.**

24 A. The transaction uses a Reverse Morris Trust to create a tax free exchange of ILEC
25 properties in fourteen states from Verizon to Frontier. Verizon will incur a series of
26 restructuring transactions to accomplish the merger. Verizon will transfer the assets
27 and liabilities of its operating companies in the fourteen states, including Verizon
28 Northwest, to a subsidiary company called Spinco. Spinco will then be transferred to
29 Frontier.

30 The total value of the transaction is estimated to be approximately \$8.5
31 billion. Verizon stockholders will ultimately receive approximately \$5.2 billion in
32 Frontier common equity and Frontier will increase its debt by \$3.3 billion to make a
33 special cash payment to Verizon. To qualify for a Reverse Morris Trust, Verizon
34 shareholders will need to have a 50 percent or greater equity stake in Frontier after

1 the merger. It is estimated that Verizon stockholders will have an equity stake
2 between 66 to 71 percent of Frontier if the transaction is completed and Frontier's
3 existing stockholders would collectively own 29 to 34 percent of the company.
4

5 **Q. Why is there a range of percentages for Verizon stockholders and the existing**
6 **Frontier stockholders after the merger?**

7 A. The number of Frontier shares of common stock issued to Verizon shareholders is
8 based upon the average price of Frontier shares. The merger agreement provides for
9 the issuance of shares at Frontier's average share price with an upper limit of \$8.50
10 per share or a lower limit of \$ 7.00 per share. For example, if Frontier's average
11 price exceeds \$8.50 per share, the calculation of the number of shares issued to
12 Verizon shareholders is $\$5.2 \text{ billion} / \$8.50 = 611 \text{ million shares}$ or 66 percent. If
13 Frontier's average price is less than \$7.00 per share, performing the calculation
14 would result in Verizon shareholders having 71 percent equity stake after the merger.
15

16 **Q. Will Verizon NW survive the transaction?**

17 A. Yes. However, the Applicants have indicated that Verizon NW will be renamed
18 Frontier NW after the merger.
19

20 **Q. Will Frontier be constrained in raising capital if this transaction is completed?**

21 A. Yes. To evaluate the potential harm I analyzed the companies' debt ratings with the
22 major credit rating agencies. The three primary agencies that issue debt ratings are
23 Moody's, Standard and Poor's and Fitch. The debt ratings of the highest quality

1 companies are Aaa for Moody's and AAA for Standard and Poor's and Fitch. The
2 lowest rated companies are C (Moody's) and D (Standard and Poor's and Fitch). For
3 the remainder of this discussion, I will refer to Standard and Poor's ratings. The
4 ratings are split between two major categories, "investment grade" and "below
5 investment grade or junk bonds." Companies with bonds considered to be investment
6 grade are rated from AAA to BBB by Standard and Poor's. Companies with bonds
7 considered to be below investment grade or junk bonds are rated from B to D by
8 Standard and Poor's.

9
10 **Q. How do Verizon and Frontier compare based on debt ratings?**

11 A. Verizon is rated A by Standard & Poor's. Frontier has a rating of B which falls into
12 the "below investment grade or junk bond" category.

13
14 **Q. What can we conclude from the debt ratings?**

15 A. In my opinion, there are financial risks that are likely to cause harm to the Verizon
16 NW Washington customers because Frontier has a lower debt rating than Verizon.
17 The lower debt rating of Frontier indicates the company will have less access to bond
18 markets than Verizon presently enjoys and Frontier will also incur higher interest
19 rates than Verizon. Data from the various agencies confirms companies with lower
20 debt ratings will incur higher interest rates on bonds, experience higher yields, and
21 incur more defaults than companies with higher ratings.

1 **Q. Does Frontier’s dividend policy contribute to these risks of the proposed**
2 **transaction?**

3 A. Yes. Historically, Frontier has used a high percentage of its free cash flows to fund
4 its dividend payments to common stockholders. Following the announcement of this
5 transaction, Frontier stated it will reduce its dividend payment from \$1.00 to \$.75 per
6 share. Despite this reduction Frontier estimates it will continue to pay 60 to 70
7 percent of its free cash flow in dividends.¹ This practice is inconsistent with a
8 strategy of building additional broadband infrastructure, investing in next generation
9 operating support systems (OSS) and improving Frontier’s debt-to-EBITDA ratio, a
10 key driver of the company’s credit rating.

11 Frontier has made representations that it will expend capital to deploy
12 broadband services to Washington customers not able to currently receive that
13 service from Verizon NW. Frontier will also continue the build-out of fiber to the
14 premises (Verizon’s “ FiOS” offering) to fulfill Verizon NW’s commitments made to
15 cities that have granted franchise rights to Verizon NW for those services. Response
16 to Staff data request No. 110, Exhibit No. ____ (WHW-2), indicates the FiOS
17 Washington build-out commitments made by Verizon NW to the franchising cities
18 will be accomplished between the years 2010 and 2014. There is one caveat
19 indicating the fiber build-out may be postponed for “events outside of Verizon
20 control and certain density requirements.” Frontier’s assertion that it will build-out
21 broadband DSL service to smaller communities in addition to completing Verizon’s
22 build-out of FiOS means Frontier will have to manage two major projects that will
23 compete for capital resources.

¹ Frontier Project North – Presentation to Board of Directors, May 12, 2009.

1 **Q. What are the terms for the \$3.3 billion debt Frontier needs to raise to complete**
2 **the merger?**

3 A. Unfortunately, Frontier does not have any specific information regarding the debt
4 that needs to be issued for this transaction. A conference call with David R.
5 Whitehouse, Senior Vice President and Treasurer for Frontier, indicates he generally
6 believes Frontier will have the following favorable terms:

- 7 • A projected interest rate of less than 9.5 percent (currently Mr. Whitehouse
8 estimates a rate of 8.375 percent)
- 9 • A minimum weighted maturity of five years
- 10 • Unsecured debt that is senior to all existing and future subordinated
11 indebtedness
- 12 • Covenants that are consistent with existing senior unsecured notes
- 13 • Frontier may consider bank financing that might include the stock of
14 subsidiaries or upstream guarantees as security
- 15 • No amortization of principle – debt due at maturity

16
17
18
19
20
21
22 Mr. Whitehouse cites improvement in the capital markets as the justification for his
23 optimism.

24 Thus, Frontier relies on optimistic management opinions without any
25 definitive data regarding the terms of the debt issuance.

26

27 **Q. What is the significance of an interest rate less than 9.5 percent?**

28 A. The merger agreement sets a ceiling on the \$3.3 billion debt issuance of 9.5 percent.
29 If Frontier cannot find a market for its debt at an interest rate that is 9.5 percent or
30 lower, Frontier is not obligated to pursue debt financing at an interest rate higher
31 than 9.5 percent. Even though Frontier does not have to pursue issuing debt when the

1 interest rate is greater than 9.5 percent, Verizon does have the contractual right to
2 have debt securities transferred to the stockholders or creditors of Verizon. Thus
3 Frontier's inability to obtain debt financing at a rate 9.5 percent or lower does not
4 necessarily mean the transaction is dead.

5
6 **Q. Are there other financial issues raised in the Joint Application that cause Staff**
7 **concerns?**

8 A. On page 17 of the Joint Application of part E, Frontier states "as a result of the
9 Transaction, Frontier will have a stronger balance sheet and greater cash flow
10 generation capabilities. Most notably, this Transaction will "de-lever" Frontier, i.e.,
11 it will reduce significantly the Company's debt-to-EBITDA ratio. The increased
12 financial strength is expected to improve Frontier's access to capital and lower its
13 cost of capital, which will inure to the benefit of the Washington operating
14 companies and their customers."

15
16 **Q. Why does this passage cause concern?**

17 A. The passage causes concern because the financial implications of the transaction are
18 viewed from a flawed perspective. It is immaterial to customers in Washington if this
19 transaction improves the financial condition of Frontier because Frontier does not
20 have significant business offerings in Washington. This Commission should view the
21 financial implications from the perspective of the local operating company and
22 consider the likely impact that this transaction will have on Verizon NW's financial
23 condition and its effect on Washington customers. Frontier's higher debt rating

1 compared to Verizon's means that Washington customers are likely to be receiving
2 services from a company with higher capital costs. Even if Frontier is able to
3 improve its financial condition as it predicts, it will still not be as strong as Verizon.
4 This will cause harm to Washington customers of Verizon NW.
5

6 **Q. Does Frontier expect to achieve synergies from this transaction?**

7 A. Company witness Daniel McCarthy does not directly address synergies, but he states
8 on page 18 of his testimony that "Frontier will become larger and stronger, which in
9 turn will benefit Washington customers." The growth from 2.25 million access lines
10 to more than 7 million access lines is a classic description of a company that expects
11 to see economies of scope and scale to lower its per unit costs. When Frontier
12 representatives met with Staff and Public Counsel in October, a company
13 representative confirmed that economies of scope and scale are the primary drivers
14 of the synergy estimate. This argument is also made from a flawed perspective.

15 It is important to recognize that Verizon also has economies of scope and
16 scale for its operations that flows to its operating companies, including Verizon NW.
17 According to the Federal Communications Commission's Automated Reporting
18 Management Information System (ARMIS) report, Verizon had approximately 34
19 million access lines on December 31, 2008. Verizon NW benefits from Verizon's
20 economies of scale and scope, which are based upon a much larger base of access
21 lines than Frontier. Logic dictates Verizon NW customers will not experience any
22 synergies from this transaction because the company will experience higher per unit
23 costs in the Washington operations should the company become a subsidiary of

1 Frontier. Any synergies experienced by Frontier may be beneficial to Frontier and its
2 existing customer base but not to the Washington Verizon customers Frontier intends
3 to acquire.

4
5 **Q. How were Frontier's synergy estimates developed and does this process give you**
6 **confidence in those estimates?**

7 A. Frontier explains how it developed its synergy estimates as follows:

8 Using revenue and unit information, and the underlying metrics of demand
9 activity that were available in the data room and via discussions with Verizon
10 personnel, Frontier compared its stand-alone operating performance metrics
11 to the projected view of SpinCo for the fiscal year 2013. Our functional area
12 team developed a view of incremental headcount, wage expense (see Exhibit
13 A.) and non-wage expenses (see Exhibit B.) necessary to operate the acquired
14 properties at current Frontier stand-alone performance levels.²

15
16 What is troubling about this analysis is the limited amount of information that was
17 available to Frontier at the time of its development and the resulting caveats that
18 Frontier has attached to this analysis. According to Frontier's supporting
19 documentation for its synergy claims:

20 Due to the nature of the data provided, synergy estimates by
21 functional area and by state were unable to be created. Additionally,
22 the calculation of synergies used numerous estimates and
23 assumptions, which have yet to be validated by supporting
24 documentation from Verizon. No information regarding Verizon's
25 "realignment" plan was provided prior to the determination of the
26 anticipated value of the synergies.³

27
28 Given the limited amount of information available to Frontier, there is reason to
29 doubt the company's estimate of synergy benefits. Failure to achieve synergy
30 benefits would mean less money available for investment in the network in

² Highly Confidential: Project North – Expense Synergy Analysis Overview.

³ *Id.*

1 Washington and elsewhere, or for the competing demands of Frontier's dividend
2 policy.

3
4 **Q. Does Staff have concerns about the availability of data to adequately analyze**
5 **the merger?**

6 A. Yes, we do. Telecommunications companies are experiencing rapid technological
7 and market changes from entities such as cable companies, and voice over internet
8 providers. These conditions make merger analysis of telecommunication companies
9 much more difficult than in the other industries the Commission regulates because of
10 the loss of access lines and market share to their competitors. Frontier's own
11 disclosures (discussed below) regarding the many risks attendant to this transaction
12 should raise the bar for the company to present convincing evidence that the
13 transaction will be a success. The disastrous history of recent local exchange
14 business sales by Verizon, described in the testimony of Robert Williamson and
15 other witnesses in this case make the showing of due diligence on the part of Frontier
16 even more important. The company's direct testimony does almost nothing to assure
17 this Commission that Frontier is up to the task of addressing the many risks that the
18 company admits to in its Security and Exchange Commission S-4 filing disclosures
19 (Exhibit DM-7).

20 Another factor the Company should have addressed is its ability to rapidly
21 deploy high speed internet services. However, Staff data request number 107,
22 Exhibit. No. ____ (WHW-3) states that Frontier did no operational due diligence of
23 Verizon NW plant. Thus Frontier has not ascertained its ability to deploy broadband

1 services in the more rural exchanges, which is one of the main selling points the
2 company gives for approval of the transfer of control. Even if the company installs
3 the DSL electronics in a wire center, it will not be able to provide service to
4 customers over cable pairs that have load coils and bridge taps without incurring
5 additional costs before the service can be provided to Washington customers.
6 Frontier's decision not to investigate the condition of outside plant may restrict DSL
7 service in some wire centers or lead to slow installation times, which will reduce
8 cash flows from those services.

9 Public Counsel and Staff have made significant efforts to investigate the
10 assurances by Verizon and Frontier that this transaction will have better results than
11 previous divestitures of Verizon ILEC properties. However, based upon responses to
12 data requests, Staff has been unable to confirm that the assurances given by the
13 petitioners are valid.
14

15 **Q. Can you give examples of responses to data requests that illustrate your point?**

16 A. Public counsel and Staff have repeatedly attempted to ascertain through data requests
17 the financial impact this transaction will have on Washington customers. In response
18 to these requests, the Joint Applicants have indicated that the forecasts have not yet
19 been developed or that the important business decisions have not yet been made.

20 Examples include:

- 21 • Staff asked the Joint Applicants to identify which Frontier affiliates will
22 likely engage in affiliated interest transaction with Frontier NW. The Joint
23 Applicants state that Frontier has not determined which entities will
24 engage in affiliated interest transactions with Frontier NW. The fact that
25 Frontier cannot answer this data request calls into question Frontier's
26 ability to understand what it is buying and how it will operate Frontier NW

1 in Washington. This response also makes it impossible for Staff to perform
2 any meaningful analysis to determine if this transaction will result in harm
3 to the Washington customers. Exhibit No. ____ (WHW-4).
4

- 5 • Public Counsel asked the Joint Applicants to “provide the Company’s
6 financial model ... that shows Frontier will be able to fulfill its broadband
7 build-out commitments while servicing its current debt load as well as the
8 additional debt assumed to finance the transaction.” The Joint Applicants
9 responded that no such model exists as Frontier has not made any specific
10 broadband build-out commitments. (Exhibit No. ____ (WHW-5).
11
- 12 • Public Counsel asked the Joint Applicants to provide Frontier’s most
13 recent five-year capital budget showing its projected capital additions to
14 telephone plant in Washington. Frontier responded that it does not
15 currently have access lines within Washington State and does not have a
16 five-year capital budget. Exhibit No. ____ (WHW-6). This matter is of
17 particular concern because as part of the risk factor discussion in Frontier’s
18 S-4 filed with the SEC, the company stated:
19

20 **The combined company will require substantial capital to**
21 **upgrade and enhance its operations.**
22

23 Verizon’s historical capital expenditures in connection with the
24 Spinco business have been significantly lower than Frontier’s level of
25 capital expenditures. Replacing or upgrading the combined
26 company’s infrastructure will require significant capital expenditures,
27 including any expected or unexpected expenditures necessary to make
28 replacements or upgrades to the existing infrastructure of the Spinco
29 Business.
30

- 31 • Public Counsel asked the Joint Applicants to “provide a cash flow interest
32 coverage analysis for both Frontier Communications and Verizon
33 Northwest (or the corporate entity that includes Verizon’s Washington
34 ILEC operations) before and after the merger.” The Joint Applicants
35 provided no such analysis responding in part that “there is no post-merger
36 analysis.” This analysis would help determine if Frontier’s cash flow from
37 Frontier NW would be able to fund its investment commitments (including
38 FiOS), operating expenses, interest payments on B rated debt, and
39 dividends to common stockholders.
40

41 The absence of information severely impairs the Commission’s ability to
42 determine that no harm will result Washington customers.
43

1 **Q. Is there a regulatory mechanism that can mitigate harms to ratepayers that**
2 **arise as the result of financial distress?**

3 A. Ring fencing is a term to describe certain types of restrictions intended to insulate a
4 regulated utility from legal or financial misfortunes that might befall an acquiring
5 company or its affiliates. In theory, ring fencing enables a utility to continue normal
6 business operations as a standalone company even when the parent is in financial
7 distress or bankruptcy. Typical aspects of ring fencing include dividend payment
8 restrictions and limitations on operating company debt. This Commission has
9 generally required the companies to accept “ring fence” architecture before receiving
10 approval of a merger or divestiture. Precedential cases include Scottish Power’s
11 acquisition of PacifiCorp, Bell Atlantic’s acquisition of GTE, Sprint’s divestiture of
12 United and, recently, Puget Holdings, LLC’s acquisition of Puget Sound Energy.

13

14 **Q. Would a ring fencing requirement in this case mitigate the potential harms**
15 **discussed above?**

16 A. No. Ring fencing cannot protect an ILEC from the financial risk profile of its parent
17 because most of the transactions needed to keep the operating company a “going
18 concern” are performed at the parent level. Additionally, any restriction of the
19 operating company’s dividends becomes a paper tiger because cash flows from the
20 operating company to the parent are recorded in the intercompany receivable and
21 payables accounts.

22

1 **Q. Can you provide examples of how Frontier Northwest would be heavily**
2 **integrated into the Frontier parent structure?**

3 A. Yes. As with Verizon, Frontier performs most of the functions for the operating
4 company such as executive management, accounting, treasury, human resources, and
5 legal. Frontier pays its dividends based upon EBITDA and free cash flow.
6 Restricting dividends from the operating company to the parent does not stop the
7 intercompany cash flow from the operating company to the parent. The dividend
8 restriction does not work for an entity that is not able to function as a stand-alone
9 operation. Additionally, a restriction on dividends would have to be accompanied by
10 a requirement that the company report the balances of the intercompany receivables
11 and payables on a monthly or quarterly basis so that the Commission could more
12 effectively police those transaction to ensure that the subsidiary is not overpaying for
13 services it receives or undercharging for services it provides. But even with this
14 information, this would still be a very difficult task.

15
16 **Q. Does the merger agreement itself pose problems that could potentially harm**
17 **Washington customers?**

18 A. I believe it does. On page 44 of Exhibit No. ____ (DM-7), the company summarizes
19 information about the transaction. In that summary, there is a description of a “make
20 whole” provision for Verizon in the agreement:

21 Additionally, the amount referred to in clause (1) above is subject to
22 increase by any amounts paid, payable or forgone by Verizon pursuant to
23 orders or settlements that are issued or entered into in order to obtain
24 governmental approvals in the Spinco territory that are required to complete
25 the merger or the spin-off. As a result, the number of shares of Frontier

1 common stock issuable pursuant to the merger agreement may increase, and
2 any such increase could be significant.
3

4 Generally, state commissions have been known to impose conditions on the approval
5 of mergers. The current merger agreement would require Frontier to issue additional
6 equity shares to Verizon for any amount that a regulatory body requires Verizon to
7 pay or forego for approval of the transaction. If Frontier issues more shares, that will
8 increase the total dividends Frontier must pay to stockholders (based on its
9 commitment to shareholders). Increased dividend payments would restrict cash
10 available for other purposes such as deploying broadband DSL services or FiOS and
11 other necessary capital expenditures. Therefore, any attempt to impose merger
12 conditions with a price tag on Verizon could have the perverse effect of weakening
13 Frontier.
14

15 **Q. Has Frontier disclosed risk factors that could affect its operations?**

16 A. Yes. Starting on page 24 of Frontier's S-4 filing, Exhibit No. ____ (DM-7), there are
17 thirty items identifying the risks associated with the "combined company" (i.e., the
18 combined Frontier and Spinco operations). The following is a brief list of the risk
19 factors:

- 20 • The calculation of the merger consideration will not be adjusted in the
21 event the value of the Spinco business or assets declines before the merger
22 is completed.
23
- 24 • Frontier's effort to combine Frontier's business and the Spinco business
25 may not be successful.
26
- 27 • The combined company may not realize the growth opportunities and cost
28 synergies that are anticipated from the merger.
29

- After the close of the transaction, sales of Frontier common stock may negatively affect its market price.
- If the assets contributed to Spinco by Verizon are insufficient to operate the Spinco business, it could adversely affect the combined company's business, financial condition, and results of operations.
- The combined company's business, financial condition, and results of operations may be adversely affected following the merger if it is not able to obtain consents to assign certain Verizon contracts to Spinco.
- Regulatory agencies may delay approval of the spin-off and the merger, fail to approve them, or approve them in a manner that may diminish the anticipated benefits of the merger.
- The merger agreement contains provisions that may discourage other companies from trying to acquire Frontier.
- Failure to complete the merger could adversely affect the market price of Frontier common stock as well as Frontier's business, financial condition, and results of operations.
- If the spin-off does not qualify as a tax-free spin-off under Section 355 of the Internal Revenue Code, referred to as the Code, including as a result of subsequent acquisitions of stock of Verizon or Frontier, then Verizon or Verizon stockholders may be required to pay substantial U.S. federal income taxes, and Frontier may be obligated to indemnify Verizon for such taxes imposed on Verizon.
- If the merger does not qualify as a tax-free reorganization under Section 368 of the Code, Frontier and the stockholders of Verizon may be required to pay substantial U.S. federal income taxes.
- Frontier will be unable to take certain actions after the merger because such actions could jeopardize the tax-free status of the spin-off or the merger, and such restrictions could be significant.
- Investors holding shares of Frontier common stock immediately prior to the merger will, in the aggregate, have a significantly reduced ownership and voting interest after the merger and will exercise less influence over management.
- The pendency of the merger could adversely affect the business and operations of Frontier and the Spinco business.

- 1 • The combined company will likely face further reductions in access lines,
2 switched access minutes of use, long distance revenues and federal and
3 state subsidy revenues, which could adversely affect it.
4
- 5 • The combined company will face intense competition, which could
6 adversely affect it.
7
- 8 • Some of the combined company's future competitors will have superior
9 resources, which may place the combined company at a cost and price
10 disadvantage.
11
- 12 • The combined company may be unable to grow its revenues and cash
13 flows despite the initiatives Frontier has implemented and intends to
14 continue after the merger.
15
- 16 • Weak economic conditions may decrease demand for the combined
17 company's services.
18
- 19 • Disruption in the combined company's networks and infrastructure may
20 cause the combined company to lose customers and incur additional
21 expenses.
22
- 23 • The combined company's business will be sensitive to the
24 creditworthiness of its wholesale customers.
25
- 26 • A significant portion of the combined company's workforce will be
27 represented by labor unions...that could materially disrupt the combined
28 company's ability to provide services to its customers.
29
- 30 • The combined company may complete a significant strategic transaction
31 that may not achieve intended results or could increase the number of its
32 outstanding shares or amount of outstanding debt or result in a change of
33 control.
34
- 35 • If the recent severe contraction in the global financial markets and current
36 economic conditions continue into 2010, this economic scenario may have
37 an impact on the combined company's business and financial condition.
38
- 39 • Substantial debt and debt service obligations may adversely affect the
40 combined company.
41
- 42 • The combined company will require substantial capital to upgrade and
43 enhance its operations.
44
- 45 • Changes in federal or state regulations may reduce the access charge
46 revenues the combined company will receive.

- The combined company will be reliant on support funds provided under federal and state laws.
- The combined company and its industry will likely remain highly regulated, and the combined company will likely incur substantial compliance costs that could constrain its ability to compete in its target markets.
- In the future, as competition intensifies within the combined company's markets, the combined company may be unable to meet the technological needs or expectations of its customers, and may lose customers as a result.

These risk factors are explained in greater detail in Exhibit No. ____ (DM-7) (Frontier's S-4).

Q. Are these the only risk factors presented by the Frontier?

A. No. On page 37 of the SEC Form S-4 filing, Frontier has another category entitled "CAUTIONARY STATEMENT REGARDING FORWARD-LOOKING STATEMENTS". Frontier then lists 29 additional factors that may impact the forward-looking statements.

Between the risk factors and the forward-looking statement disclosure, there are fifty nine items qualifying projections and statements made by Frontier. The most important point of the disclosures is Frontier's statement that these qualifying items may cause "material" changes in the projections.

Q. Are there other financial issues the Commission should consider?

A. Verizon NW's current parent is a large and diversified communications conglomerate with considerable and growing revenues from wireless and global IP operations. It had \$202 billion in assets and \$160 billion in total liabilities at the end

1 of 2008. During the course of that year, it received \$97 billion in revenues and
2 earned \$6.4 billion in net income. It currently maintains a debt to EBITDA ratio of
3 2.7x and an 'A' credit rating with the rating agency Standard & Poor's.
4 Frontier is primarily a provider of wireline telephone and high-speed internet
5 services provided to rural markets. It ended 2008 with \$6.9 billion in assets and total
6 long term debt, liabilities, and deferred credits of \$6.4 billion. It received revenues
7 of \$569 million and earned \$46 million in net income. As of June 30, 2009, Frontier
8 maintained a debt to EBITDA ratio of 4.6x, which is expected to decline to 3.0x on a
9 pro forma basis following the merger. Standard & Poor's currently rates Frontier's
10 senior unsecured notes as "B".

11 If the merger is approved, Verizon NW will be owned by a company with
12 less diversified operations, a smaller asset base, smaller earnings, and a lower credit
13 rating. As a result, the operating company will face greater expense and greater
14 difficulty raising capital.

15
16 **Q. Has Frontier engaged investment bankers to analyze the merger proposal?**

17 A. Yes. Both Evercore Group L.L.C. and Citigroup Global Markets Inc. have
18 expressed opinions concerning this transaction. Annex B-1 and B-2 of Frontier's S-4
19 filing contain the opinions of the firms. Both firms qualify the assumptions and data
20 used to render their opinions. Evercore makes the following statement:

21 For purposes of our analysis and opinion, we have assumed and relied upon,
22 without undertaking any independent verification of, the accuracy and
23 completeness of all of the information publicly available, and all of the
24 information supplied or otherwise made available to, discussed with, or
25 reviewed by us, and we assume no liability therefore. With respect to the
26 Projections, we have assumed that they have been reasonably prepared on

1 bases reflecting the best available estimates and good faith judgments of
2 management of the company as to the matters covered thereby. We have also
3 assumed that the Synergies are reasonably obtainable, on bases reflecting the
4 best currently available estimates and good faith judgments of future
5 competitiveness, operating and regulatory environments...

6
7 This statement can be found on Annex B-1-2. Citigroup has a similar qualification
8 that can be found on Annex B-2-2.

9 While these are favorable opinions given by the investment bankers, they rely
10 on the same information and estimates given to Staff that have been found to be
11 lacking for the purposes of determining “no harm” to Washington customers.

12
13 **V. STAFF CONDITIONS FOR MERGER**

14
15 **Q. If the Commission decides the transfer of control should be approved, does Staff**
16 **have any recommendations of conditions the Commission should require of the**
17 **petitioning parties?**

18 A. Yes. Although Staff’s primary recommendation is that the Commission deny the
19 Application, Staff realizes that the Commission may conclude that the public interest
20 would be better served by approving the transaction with conditions designed to
21 mitigate harms and to provide offsetting benefits.

22 I will, therefore, recommend conditions pertaining to the financial issues
23 discussed above. I will then give a summarized list other conditions that are set
24 forth, and explained in greater detail, in the testimonies of Staff members Ms. Jing
25 Roth, Mr. Robert Williamson, Ms. Kristen Russel, MR. Rick Applegate, MS. Jing
26 Liu, and Ms. Suzanne Stilwell. Aside from my own testimony set forth above, all of

1 the other Staff witnesses' testimony begins from the assumption that the Commission
2 has decided to approve the transaction with conditions, despite Staff's primary
3 recommendation of denial.
4

5 **Q. What conditions do you recommend should be placed upon the companies if the**
6 **Commission approves the transaction?**

7 A. My recommendations are as follows:

- 8 1. For a period of five years from the date of close, Frontier must submit a
9 quarterly report to the Commission listing the change in the intercompany
10 receivables and payables accounts of Frontier and Frontier NW by month
11 during the quarter. Frontier must also include in this quarterly report the
12 dividend amount Frontier NW will issue to Frontier, the parent. This report
13 must also show the dividend payment by quarter Frontier declares to be paid
14 to its shareholders. (These conditions will provide Staff the necessary
15 information to track Frontier's performance rather than looking at a "ring
16 fence" requirement.)
17
- 18 2. Frontier must petition for an Alternative Form of Regulation (AFOR) within
19 five years after the transaction closes. The filing should contain a pro forma
20 results of operations, cost of capital and an AFOR proposal.
21
 - 22 a. The results of operations should utilize this Commission's
23 format using a historical test period with restating and pro
24 forma adjustments to the test period. Restating adjustments
25 should remove non-recurring transactions recorded in the test
26 period and pro forma adjustments should be made using the
27 "known and measurable" standard.
28
 - 29 b. For this filing, the cost of capital should be based upon
30 "investment grade" debt and equity. Verizon NW currently
31 enjoys an investment grade debt rating by the various
32 agencies. Washington customers should not be required to
33 bear higher capital costs due to Frontier's lower ratings in this
34 filing.
35
 - 36 c. There should also be an AFOR proposal in this filing.
37
- 38 3. The company must not seek to recover from Washington ratepayers any
39 separation, branding and transition costs. These costs should be borne by the

1 stockholders. The types of costs in this category include but are not limited
2 to, transaction costs (accounting, banker, legal advisor, investment banker,
3 and other fees), severance costs, new employees employment costs, and the
4 costs of developing and establishing the brand name. The company must
5 record these costs in separate subaccounts on the parent and the operating
6 company's accounting records.

- 7
8 4. After the close date, Frontier will submit a quarterly report to the
9 Commission identifying synergy savings for the quarter and cumulative year
10 to date savings, the accounts the synergies were recorded in for both Frontier
11 and Frontier NW. The first report should identify the method Frontier used to
12 calculate the synergies. Any subsequent methodology change of the synergy
13 calculation will require a report by the company explaining the change and its
14 affect from the previous calculation. This report should be submitted to the
15 Commission until all the synergies from this transaction have been realized.
16

17
18 **Q. What conditions does Staff witness Jing Roth recommend?**

19 A. Staff witness, Jing Roth, recommends the following conditions:

- 20 1. Residential rates for flat and measured rates must be capped for three years
21 after the close of the transaction.
22 2. "Grandfathered" services offered to existing Verizon customers must
23 continue to be offered for a minimum period of six months after the date of
24 close.
25 3. Verizon Northwest customers wanting to change intrastate long distance
26 services to another carrier must be able to do so without incurring a Primary
27 Interexchange Carrier (PIC) charge for a period of ninety days after the close
28 of the transaction.
29 4. Frontier Northwest must waive early termination charges for any current
30 Verizon Northwest customers choosing to use other alternatives for their
31 bundled and high speed internet services for a minimum period of twelve
32 months after the close date.
33 5. Frontier Northwest must continue to offer and provide bundled services
34 available to Verizon Northwest customers in Washington for a minimum
35 period of twelve months.
36
37
38

39 **Q. What conditions does Staff witness Robert Williamson recommend?**

40 A. Mr. Williamson's recommendations relate to operations support systems (OSS).

41 They are as follows:

1. Verizon/Spinco must replicate OSS for all customer transactions, both retail and wholesale, and use these replicated systems for a minimum period of ninety days before the close date.
2. Within ninety days prior to closing, Frontier must complete system testing and issue a report to the Commission validating that the OSS are operational in accordance with the terms of the merger agreement.
3. Ninety days before the close date Verizon/Spinco must meet the retail service quality standards set forth in Kristen Russell's testimony and wholesale quality of service should not show substantial degradation.
4. Verizon must create an archive of all data transferred to the replicated systems. This data should be maintained by a third party at Verizon's expense for a period of twelve months following the transactions close date.
5. Frontier must report quarterly for a period of four years following the close date concerning business and repair office operations and billing system issues to the Commission.
6. Frontier must issue quarterly reports to the Commission on any consolidation of network operations changes and staffing levels.
7. When the OSS is converted to Frontier, a neutral third party must be engaged to audit the conversion results.
8. Sixty (60) days prior to cutting over any operations support systems, Frontier Northwest must provide notice to CLECs of any changes in functionality and e-bonding.
9. Frontier Northwest must maintain functionality performance and e-bonding at a level that at least equals to what Verizon Northwest has been providing pre-transaction.

Q. What conditions does Staff witness Kristen Russell recommend?

A. Ms. Russell's recommendations pertain to service quality and yellow page imputation. Her recommendations are as follows:

1. Frontier Northwest must augment the offerings of Verizon's Service Performance Guarantee (SPG). In general, staff recommends that the programs be changed to increase credits to customers for failed service repairs and installation.
2. Frontier Northwest must report monthly its service quality report and customer credits associated with SPG.
3. Customer credits associated with the services quality benchmarks would be set at approximately two percent of Verizon Northwest's intrastate operating revenue for 2008.
4. Service quality benchmarks would be similar, if not identical, to Qwest's Service Quality Performance Plan (SQPP) standards.

- 1 5. Frontier Northwest must submit an annual benchmark report card to its
2 customers and the Commission.
3 6. Frontier Northwest may not seek to recover customer performance issue
4 credits in future rate cases.
5 7. Frontier must assume the terms of previous Commission orders affecting
6 Verizon NW, including imputation of yellow page sale gain.

7
8
9
10 **Q. What conditions does Staff witness Rick Applegate recommend?**

11
12 A. Mr. Applegate recommends conditions relating to wholesale service quality. They
13 are as follows:

- 14 1. Frontier Northwest must continue to offer the current interconnection and
15 wholesale service offerings of Verizon NW for three years following the
16 close date.
17 2. Frontier Northwest must participate in a Commission docket to set wholesale
18 service quality standards for the various metrics contained the Joint Partial
19 Settlement Agreement (JPSA). The docket will review the current standards
20 and explore the merits of setting and executing remedies.

21
22
23
24 **Q What conditions does Staff witness Jing Liu recommend?**

25
26 A. Ms. Liu recommends that Frontier Northwest be required to:

- 27
28 1. provide broadband services to ninety five percent (95%) of its customers
29 state-wide by the end of 2013 with annual milestones and with minimum
30 speed capacity requirements;
31 2. provide broadband to 90 percent of its customers in each wire center
32 classified in UNE Zones 3-5 by the end of 2013;
33 3. submit an initial broadband deployment plan within 90 days of merger
34 approval and thereafter a progress report to the Commission annually; and
35 4. Make a stand-alone DSL offering available to consumers and continue to
36 offer stand-alone DSL services at the current Verizon rates, terms and
37 conditions for 12 months after the merger closing.

38
39
40 **Q. What condition does Staff witness Suzanne Stillwell recommend?**

41 A. Ms. Stillwell recommends conditions relating to the Washington Telephone

42 Assistance Program:

- 1 1. Frontier must provide a \$75 credit to any WTAP-qualified customer that fails
2 to receive the appropriate discount, credit, or waiver of the deposit, within the
3 first bill cycle after application. This credit shall remain in place for three
4 years following the transaction.
5 2. Frontier must report to the Commission, every month for three years
6 following the transfer, certain information pertaining to its processing of
7 WTAP applications.
8 3. Frontier must provide clear scripts to its customer service and sales
9 representatives so that each WTAP customer is aware of the restrictions of
10 bundled service on WTAP credits. Further, this information should be clearly
11 noted on its Web page and other marketing material.
12
13
14

15 **Q. Does this conclude your testimony?**

16 A. Yes, but I want to reiterate that Staff strongly encourages the Commission to deny
17 the Application to transfer control to Frontier for the reasons previously cited.
18
19
20